Pearl Meyer

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Hot Topics in Private Biotech

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Private companies face unique challenges that their public company counterparts do not. Access to reliable market data on pay levels and practices is just the beginning. Private companies are competing for the same board, executive, and broad workforce talent, often with fewer resources. Private company financing models impact cash compensation, and equity—one of compensation's most important incentive tools—works differently than public company stock given illiquidity, share pool constraints, and market grant practices.

The current private financing environment and public stock market volatility have only made addressing these challenges more pressing of late. Companies are staying private longer than before, which prolongs the time to liquidity and has forced companies to raise additional private capital, which dilutes equity positions further. Public stock market volatility has led private company option holders to be more pragmatic about the risk-reward potential in the sector and has tempered expectations around the upside of private company grants. Currently, three topics are frequently being raised with private company compensation committees.

Board of Directors Compensation

Private companies draw board talent from the same pool as public companies. Historically, private company stock options have been an effective tool to attract independent directors who are willing to accept the risk of an early-stage company in exchange for the upside potential of stock options. The market conditions may be making this more difficult now. There is an increased likelihood of further dilutive private financings before any potential liquidity event and this may reduce the perceived value of an initial grant. Further, many public companies of the last IPO vintages are trading so far below their offer prices that even the private company options those directors hold are in many cases underwater.

These two forces are combining to pressure what have been typical ownership percentages for independent board members. At the same time, any need to spend (or reserve) more of the equity pool for board members will come at the expense of what companies have available to spend on their employee teams.

This may be a contributing factor to the recent rise of cash retainers with annual amounts that are quickly approaching, and in some cases even matching, public company norms. In some instances, private companies have even extended beyond the norms of public companies at their size and stage to bring headline names onto boards. While this expenditure is small in nature relative to other cash outlays the company must make, it does create an ongoing cost.

Cash Compensation Compression

Among the executive ranks, cash compensation is often materially lower at private companies. Salaries can trail by double-digit percentages and target bonus opportunities may be five or ten percentage points lower as a percent of salary. There are a few reasons: first, the scope of executive responsibility—particularly for the CEO, CFO, and CMO—at public companies is considerably larger with respect to investors and the Street. This involves a material time commitment and increases liability not only for the organization, but the executives themselves. Budgets are also a factor as public companies have greater access to capital, which can support higher ongoing fixed costs, including cash compensation. And finally, it is often the case that private company executives can be willing to forgo some cash in the near term in exchange for a large equity stake in a private company that has "home run" opportunity.

However, this isn't necessarily the case at lower levels in the organization. The broader workforce tends to favor cash and may not view equity opportunities to be as valuable. This can be due to individual needs, limited understanding of stock options, or negative past experiences with equity. This segment of the workforce often holds more interchangeable positions where candidates may be weighing offers for similar roles at private and public companies. As a result, salaries have generally converged at the lower levels across private and public companies within the sector.

This causes salary compression in the middle of organizations. We see it most at the senior director, VP, and SVP levels as the market-driven cap on executive salaries leaves very little room for differentials between levels. Salary increases for this middle group can be limited year-to-year absent promotions. Management teams and HR must educate employees and effectively communicate the value propositions of total compensation packages. With the financing environment lengthening the period that companies remain private, the compression challenge is only becoming more acute, driving the need for more and better communication.

Refresh Grants

Most private companies default to granting equity awards to all incumbent employees periodically. New hires receive a grant upon joining, but it may then be years before a new grant is issued. Private companies just do not have sufficient shares in the equity pool to initiate annual equity award programs with meaningfully sized awards. Instead, the prevailing practice is to use financings as an opportunity to provide new grants. This recognizes that employees have been diluted—meaning their ownership is now lower on a percent of company basis—and capitalizes on the share pool expansions that typically accompany these capital raises.

As financing timelines have been prolonged there have been longer gaps between awards. The longest-tenured employees are mostly, if not fully, vested, and with no (or few) additional grants on the horizon and low likelihood of a near-term exit event, the value of equity as a retention tool is reduced or even eliminated. Private companies are pressed to address hiring needs with even tighter pools, or to go back to existing investors and ask them to take on additional dilution by expanding the pool.

This is bringing forth a frequent conversation among many compensation committees and management teams and they are asking the same question when contemplating refresh programs. Should we allocate equitably amongst the workforce (i.e., the "peanut butter" approach) as has been typical practice, or should we target our high performing and/or high potential employees, concentrating the small equity pool availability amongst the group that is most critical to the business? The right answer is going to be different depending on each unique situation, but some of the factors to consider are:

- How dilutive was the round?
- How do post-financing ownership levels compare to competitive market data and how does that align with the company's overall compensation philosophy?
- How vested is top talent (i.e., do their holdings still provide incentive and retention benefit)?
- What is the available pool to work with and what needs to be reserved for future needs?

Effectively using equity as an incentive and retention tool remains critical for private companies, yet becomes increasingly tricky in highly uncertain market circumstances because it is illiquid. In the current environment, many employees who are still early in their careers have not had positive experiences with equity. For a refresh program to be successful, companies may need to more thoughtfully design—and potentially change—the program using the questions above and communicate the value proposition to employees, which may involve providing some level of education.

Conclusion

Private companies are best served by addressing compensation challenges holistically. Understanding market data, where available, and how others have sought to deal with similar issues is key to determining what the optimal solution is at any given point in time. If these issues have not yet warranted a discussion amongst your compensation committee, thinking ahead of time about how your company might respond could provide a head start. Further pressure on the sector may intensify these current challenges as well as likely introduce new ones. Being proactive and thoughtful will be the keys to success in these times of uncertainty.

About the Author

Matt Molberger is a managing director at Pearl Meyer. He consults primarily with companies in the life sciences and technology sectors. Matt works with clients to develop comprehensive executive compensation programs that support long-term business objectives. He specializes in pay benchmarking, incentive plan design, pay-for-performance alignment, security arrangements, and CD&A disclosure. Matt's client experience ranges from pre-IPO planning to supporting Fortune 500 companies throughout the annual compensation cycle.

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